ECONOMIC OUTLOOK

bounty management
unique investment insight

Bounty Management Corporation
The Rice Building
10 High Street, 9th Floor
Boston, Massachusetts 02110
t 617.357.8285 f 617.451.9064

January 2016

Draining the Swamp After the Money Flood

Seven years to the day after setting the funds rate at zero, on December 16th the Federal Reserve lifted its policy rate to a range of 0.25% to 0.50%. Since mid-2008, asset purchases and emergency programs have boosted the Fed's balance sheet from $900 billion to $4.5 trillion and created a vast swamp of liquidity. Trillions in asset purchases and zero interest rates drove equity and riskier asset prices higher as savers moved money from low yielding assets into riskier investments. Since the end of asset purchases by the Fed in the fall of 2014, the S&P 500 index has traded flat to slightly lower, punctuated by a long awaited correction of over 12% last summer. As policymakers look to further drain the liquidity swamp in 2016, investors will be monitoring the global economic and market strains that emerged from beneath the water line in 2015. Witness the recent weakness in the high yield bond market in the fourth quarter, when several funds shut down operations. China, Russia, and Brazil are still experiencing sharp slowdowns or severe recessions, with a strong dollar exacerbating trade. After a decade of steady appreciation, the MSCI emerging markets currency index fell -4.3% in 2014 and another -7.2% in 2015. By mid January, the Chinese equity market had fallen over 18%.

As Fed Chair Yellen charts a course for higher rates based on the assumption U.S. economic momentum will remain solid, other major global central banks retain policies for easier money and lower rates. The European Central Bank (ECB) in December extended its quantitative easing program by six months, to March 2017, at a pace of €60 billion per month. Many analysts expect the Bank of Japan (BOJ) to add even more stimulus in 2016. Finally, in a break from history, the Bank of England - usually a few months behind the Fed in historical tightening cycles - is not expected to move until 2017. And even though the U.S. is raising rates, Wall Street dealers forecast the Fed will keep its $2.5 trillion Treasuries portfolio and its nearly $2 trillion in mortgage-backed securities intact until 2017. As Cleveland Fed President Loretta Mester told Reuters this month, "There's no compelling reason now to shrink the balance sheet." So even with the recent rate hike, there is no talk of draining the pool of over $4 trillion in assets.

U.S. Economy

The consumer and to a lesser extent domestic residential investment have powered growth in recent years, though the fourth quarter is likely to show both decelerating. Net exports have subtracted on average three-quarters of a percentage point from top-line GDP growth in the past four quarters, no surprise given the strong U.S. dollar and very moderate foreign growth. Household spending plus business and residential investment ran at a 3% pace in 2015, firmer than the 2.1% y/y pace of overall GDP growth. Spending on business equipment and software jumped 9.9% annualized in the third quarter, while structures spending fell

7.2% with the mining and energy sector a clear drag. The latest estimate of 3rd quarter GDP growth was revised down to 2.0% primarily due to a widening gap in inventories over sales. The higher inventories are due to the global slowdown in growth, the stronger U.S. dollar making our products more expensive, and weakness in oil related firms. Consumer demand is not keeping pace with production. The Federal Reserve in December projected 2015 GDP growth of 2.1% and sees 2% growth prevailing over the long run. The median Fed member now sees the Fed funds rate ending 2016 at 1.4% and 2017 at 2.4% - still well above what the market expects. We see overall 2016 U.S. growth stuck in a range of 1.5% to 2.0%.

Employment and Wages

Hiring slowed to about 200,000 jobs per month in 2015 after averaging 260,000 per month in 2014. A 5% unemployment rate should be generating a pickup in wages and inflation according to economic models used by many at the Fed. However, with recent data showing soft core inflation and a tighter job market, even Fed Chair Yellen has acknowledged that uncertainties and controversy regarding these simplified models mean faith in accelerating inflation will need to be carefully evaluated against incoming data. Broader slack as measured by the U-6 unemployment rate fell to 10.0% of the labor force, still at a level last seen in the aftermath of the 2001 recession. On the wages front, the Employment Cost Index remained steady at 2.0% y/y in the third quarter, matching its average since 2010. Real compensation per hour surged 3.4% y/y in the third quarter as price growth plunged, a jump that stands in stark contrast to the cumulative 0.3% increase recorded from the fourth quarter of 2009 to the third quarter of 2014.

Real Estate

The S&P Case-Shiller home price index rose 5.5% y/y in October with recent months a bit stronger than the 5% that prevailed earlier in 2015. A limited supply of homes amid a continued tightening in the labor market is driving price gains, though first-time buyers are still constrained by income gains that fail to keep pace. Affordability, as measured by the National Association of Realtors first-time homebuyer index, was the lowest in nearly 7 years, in the third quarter. Rents continue higher and rent inflation now represents the bulk of any upward pressure in the consumer price index. Average apartment rents rose 4.6%, the biggest gain since before the recession. Rent is currently adding a full percentage point to inflation.

Consumer and Manufacturing

Consumer confidence improved in December as consumer's remained positive on the economy and the job market. Higher confidence was in stark contrast to recession conditions in corners of the manufacturing sector. The strong dollar, weak global growth, and a depressed energy sector left the ISM Manufacturing Index at its lowest level since mid-2009 at 48.2 (a reading below 50 indicates contraction) in December. Historically, ISM readings have a strong track record as a leading indicator of economic downturns, but the effects are a bit muted since manufacturing employment is now below 9% of total U.S. payrolls, down from 25% in 1970. The Chicago Business Barometer contracted at the fastest pace since July 2009, falling 5.8 points to 42.9 in December from 48.7 in November. Prospects remain bleak heading into 2016 as inventories are high in relation to shipments while the wholesalers stocks-to-sales ratio at 1.31 exceeds all but a few readings in the last 15 years including recession spans. Weak manufacturing numbers do not bode well for the economy or the Fed's ability to raise rates.

World Economy

Europe

GDP growth in the eurozone decelerated from a 2% annual rate in the first quarter of 2015 to 1.2% in the third quarter primarily due to lower trade. Sensing that the eurozone needs more time to recover, the European Central Bank extended its €60B per month bond buying program by six months, through March 2017, and lowered the deposit rate to -0.3%. In addition, ECB President Draghi noted that the December enhancements will add €680 billion in liquidity (6.5% of GDP) over the next four years. In effect, this brings ECB quantitative easing in line with its Fed and BOJ counterparts, cements it is here to stay, and reinforces a low-rate environment.

Nevertheless, Europe has been a brighter spot within the global manufacturing slowdown. Country PMI surveys are generally at more favorable levels than in other regions. The Eurozone Composite PMI was steady at 54 in December, lifted by an upturn in the manufacturing component to 53.1 (52.0 as of September) and some moderation in services. However, the latest reading is well over a point above its long-term average and the fourth quarter was the highest in over four years. Official GDP data for the current quarter may again understate the pace of activity as portrayed by business services, as mild weather restrains utility production. European unemployment has fallen to 9.3%, the lowest level in six years. Northern Europe has been a consistent source of strength and some of the southern European countries such as Spain have started to recover. Germany's economy expanded by 1.7% in 2015 and benefited from low unemployment and rising wages. Outside the eurozone, U.K. growth slowed to 2.0% annualized from 2.8% in the 2nd quarter. Similar to the U.S., exports have been hurt by the strong pound and lower global demand.

Japan

Policymakers are at a crossroads, as Prime Minister Abe's economic reform platform - an implicit goal of driving down the yen, coupled with rough contours of fundamental economic reforms - has yielded a mixed bag. Inflation is higher, but well short of the 2% target. Real wages are lower, economic growth has been choppy and weak, and there are few clear signs of a corporate investment surge. The Bank of Japan's bias remains dovish with inflation at 0.1% y/y in November (0.9% ex-food and energy), and GDP growth averaging just 0.2% annualized in the second and third quarters. Consensus estimates for 4th quarter growth are below negative 1% and falling. Monetary stimulus is running at ¥80 trillion annualized ($670 billion per year) and Japan's debt to GDP remains at 245%, a level the IMF warned is "unsustainable."

China and Developing World

Chinese equity market volatility continued in 2016 as the Shanghai composite fell 7% on the first day of the year. The transition from a credit-fueled investment and export growth model to domestic consumption is occurring in an environment of severe oversupply from those "old" growth drivers, a key factor now depressing global oil and commodity prices. In December, the Ministry of Finance pledged to cut taxes and some areas of spending while boosting social welfare programs. A manufacturing slump deepened in December, with both the government (49.7) and private sector (48.2) purchasing manager surveys in contraction territory.

Emerging markets outside of China are also experiencing slower growth. Russia, Brazil, and most of South America are either close to or in recession. Brazil's recession accelerated in the third quarter with real GDP down 4.4% from a year earlier. In contrast to other major developing countries, growth in India remained

robust last year buoyed by strong investor sentiment and the positive effect on incomes of the fall in oil prices. The World Bank estimates a 7.8% growth rate for India in 2016. The World Bank recently cut its world growth forecast for 2016 from 3.3% to 2.9% after disappointing world growth of 2.4% in 2015. Our world GDP forecast is 2.5% supported by increased growth in the eurozone, but offset by struggling emerging market growth and an increased risk of currency devaluations.

Investment Perspective

The Federal Reserve raised rates based on data that shows the U.S. economy is recovering: more people are working, working more hours per week, and making more money per hour than a year ago. In addition to job growth, housing is improving, debt is down, gas is lower, and consumer confidence is up. On the other hand, weak overseas economies, low commodity prices, and a strong dollar have chilled trade flows and earnings, a sign of trouble for U.S. economic growth. Oil futures are trading below $30 as supply remains resilient in the face of falling prices. Corporate profits have likely peaked and are moving lower with the 3rd quarter down -1.6% and 4th quarter -4.2% as profit margins are under pressure. Market internals were negative with more stocks declining than advancing. In 2015, large swaths of the market declined with the Dow off -2.2%, MSCI International –3.3%, and the Russell 2000 -5.7%. If not for a few large tech stocks, the returns would have been even lower.

The biggest question for 2016 will be the effect of a slowing world economy on U.S. growth. Although U.S. growth has been a mediocre 2.0% – 2.5% since the financial crisis, we have been a safe haven in a volatile world. However, instead of upward economic data, we already see signs of U.S. weakness in manufacturing which holds a shrinking share of GDP, but is a leading economic indicator. Manufacturing industries account for the bulk of S&P 500 profits that are increasingly reliant on foreign sales: in this decade, U.S. firms have earned 27% of their profits overseas vs. 17% in the 1990's. For the equity market, the fundamental hurdles are external risks and renewed earnings growth. Analysts have dropped their earning's forecasts to mid or low single digit growth in 2016 from about 10% a few months ago. Cash and bonds, even with the Fed increase in rates, are still yielding little, but serve a role to balance portfolios during times of turbulence. Stocks are still the best alternative longer-term, but equity valuations remain stretched in some pockets. Our view is that fundamentals, such as a strong balance sheet and top-line growth, will matter more. We continue to see the most value in pharmaceuticals, industrials, telecom, and some technology. Dividends remain an important component. The market will continue to have bouts of volatility especially as the Fed tries to reverse the effects of monetary easing. Raising rates without addressing the $4.5 trillion bloated balance sheet (also know as the liquidity swamp) may be a mistake. If the Fed were forced to reverse course and cut rates, it would only signal confusion and a lack of credibility at the Fed. Our objectives given the situation are to preserve purchasing power and grow capital over the long-term. We will as always remain vigilant and patient.

December 31, 2015
DJIA: 17,425.03
S&P 500: 2,043.94

About Bounty Management
Bounty is an investment firm based in Boston that provides personalized, professional management of investment portfolios. Since 1971, we have successfully managed investment, trust and retirement portfolios for clients including individuals, families, non-profits, and endowments. Our primary goals are to preserve purchasing power and to produce long-term appreciation of capital.

If you would like to learn more about our investment management services, performance, and how we can help you, please give Ray Bligh a call at (617) 357-8285 or access our web site at http://www.bountymanagement.com.

This report, prepared by Bounty Management Corporation, is provided for informational purposes only. The report does not contain investment recommendations and was issued without regard to the financial situation or particular needs of any specific recipient. Bounty Management does not accept any liability for any direct, indirect or consequential damages or losses arising from any use of this report or its contents. The information in this report was obtained from sources believed to be accurate, but we do not guarantee that it is accurate or complete. The opinions expressed herein are strictly those of Bounty Management, are made as of the date of this material, and are subject to change without notice. There is no guarantee that the views and opinions expressed in this communication will come to pass. Please consult with your personal tax advisor before making tax-related investment decisions. **Past performance is no guarantee of future results.**